DOW THEORY LETTERS INC.

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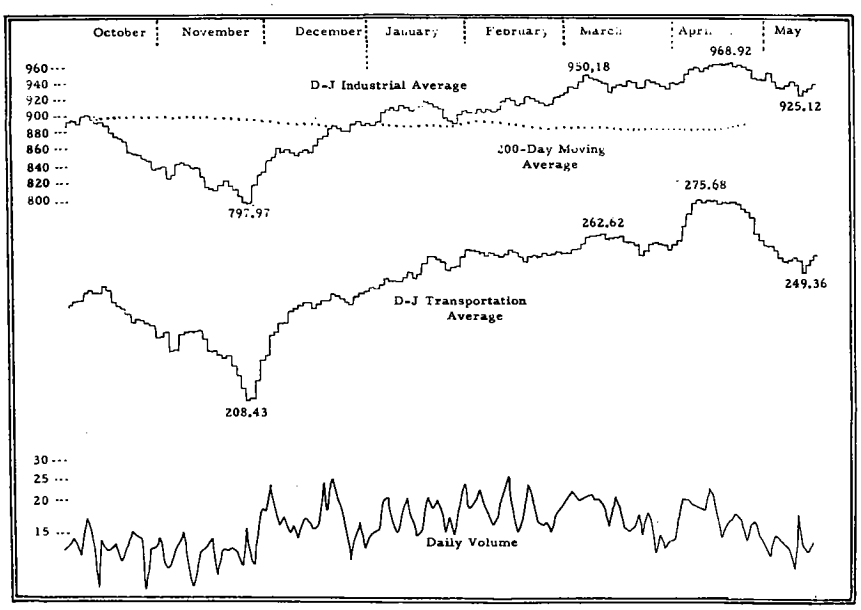
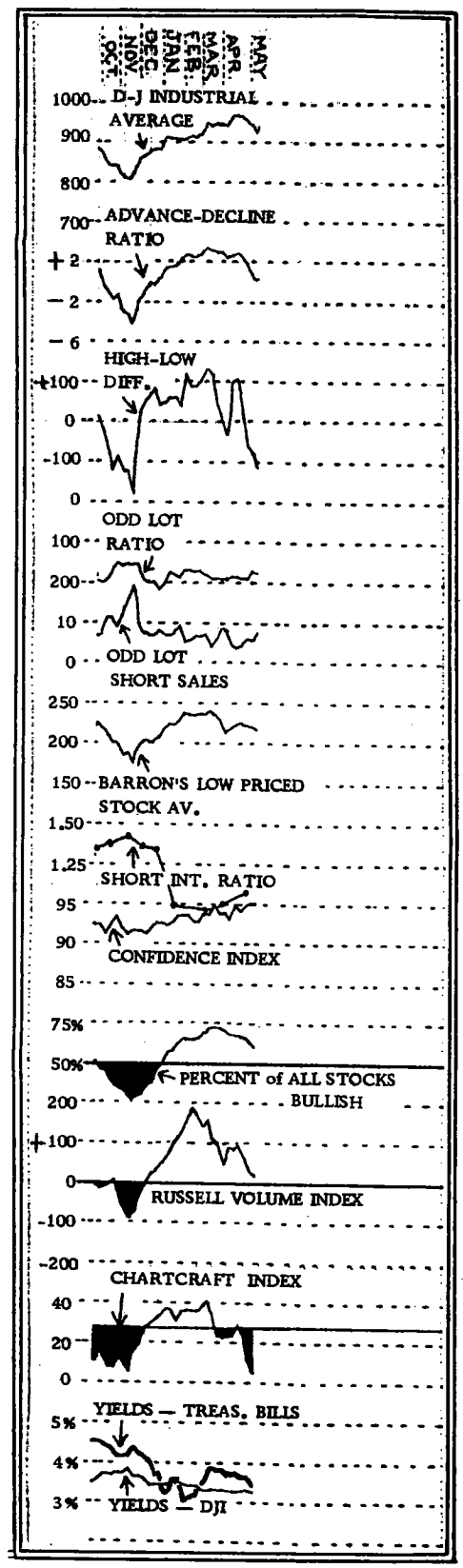
THE MARKET: The D-J Transportation Average recorded its 1972 recovery high of 275.68 on April 12. Three trading days later, on April 18, the D-J Industrial Average recorded its own closing high of 968.92. Technical weakness was clearly visible at the time with daily new lows running in the 60's, the Utility Average caving in and the advance-decline ratio sagging badly. All this was duly noted in these reports. Towards the end of April the Industrial and Transportation Averages joined the downside parade and the top had been formed.

By May 9, the Transportation Average had sunk below its late-January low point (see chart at bottom of the page). On the same day the Industrial Average closed at a low of 925.12, its lowest level since February 24. From the standpoint of Dow Theory, the two May 9 lows are significant. The quality of the rally from the May 9 lows can now be studied, and already it is seen that the advance-decline ratio is lagging with most rally days producing as many as 400 to 500 declines.

But the more important test will come on the next decline. At that time, it will be important to see if one or both Averages can hold above their May lows of 925.12 (Industrials) and 249.36 (Transportation). If those two lows hold, it is probable that in due time the market will make another assault on the April highs. On the other hand, if the May 9 lows are penetrated by both Averages, the probabilities are that we will be in for a rather unpleasant summer.

The weekly chart on page 2 serves to put the whole picture into larger perspective. Here we see the disparity between the Industrials and Transports on the one hand and the Utilities and the A-D ratio on the other. Note that on the recent decline the A-D ratio broke well below its March low, and that any new high in Industrials will only intensify the current flagrant divergence between the Industrials and the A-D ratio. This is, at present, the number one technical problem in the market.



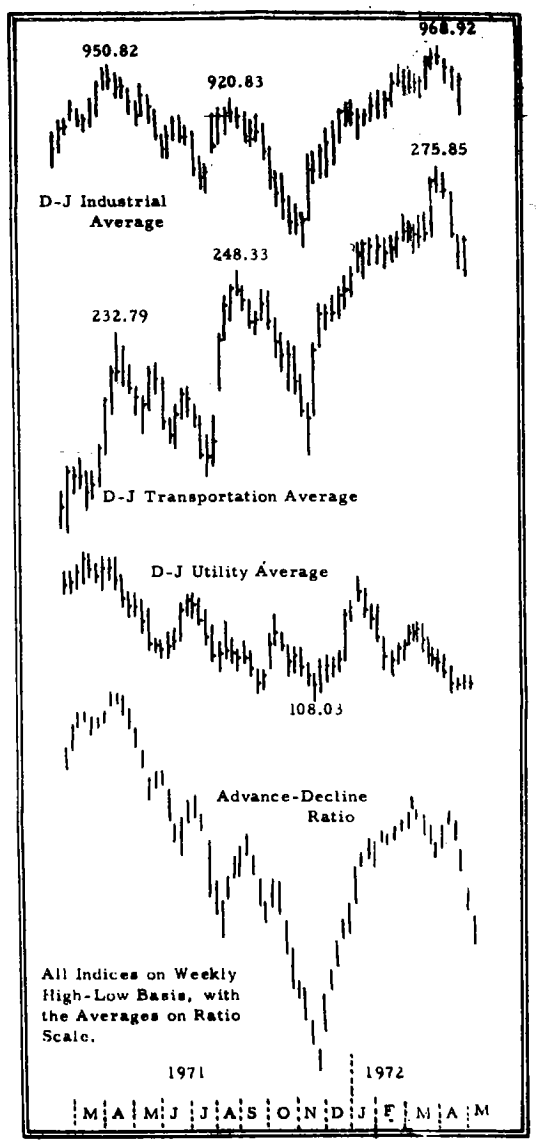


I did not plunge into the latest Vietnam picture at the beginning of this Letter, because readers are all too familiar with my views on this subject, and because I consider the current situation simply the logical outcome of two trends: (1) Hanoi's conviction that it will fight on until either the US tires, or until Hanoi wins, (2) Successive US Administrations' fears of being branded "The Administration that presided over the losing of the war in Southeast Asia."

I do not see Russia as being willing to take a frontal stand against the US over the Vietnam situation. I do not see China confronting the US with World War III either. Nor do I see Hanoi giving up the struggle. And finally, I do not see the US mining of North Vietnam ports as being successful. In other words, I see the war dragging on as it has these many years. I see it continuing to represent one of the most sickening wastes of human lives and resources in world history. I continue to see the US losing prestige because of its stand, and I continue to see untold human misery as this nation rains bombs on Asia on a scale far surpassing anything seen during World War II or any other war.

DOW ADVANCE-DECLINE RATIO: In Letter 522 (March 1) I presented my initial study of the A-D ratio of the 30 Dow Industrial stocks. This ratio is a daily computation of the plurality of advances or declines in the 30 Dow stocks, each day's plurality added (or subtracted) from the preceding day's total. For instance, if, on a given day, 15 Dow stocks advanced and 9 declined, a figure of 6 would be added to the previous day's total.

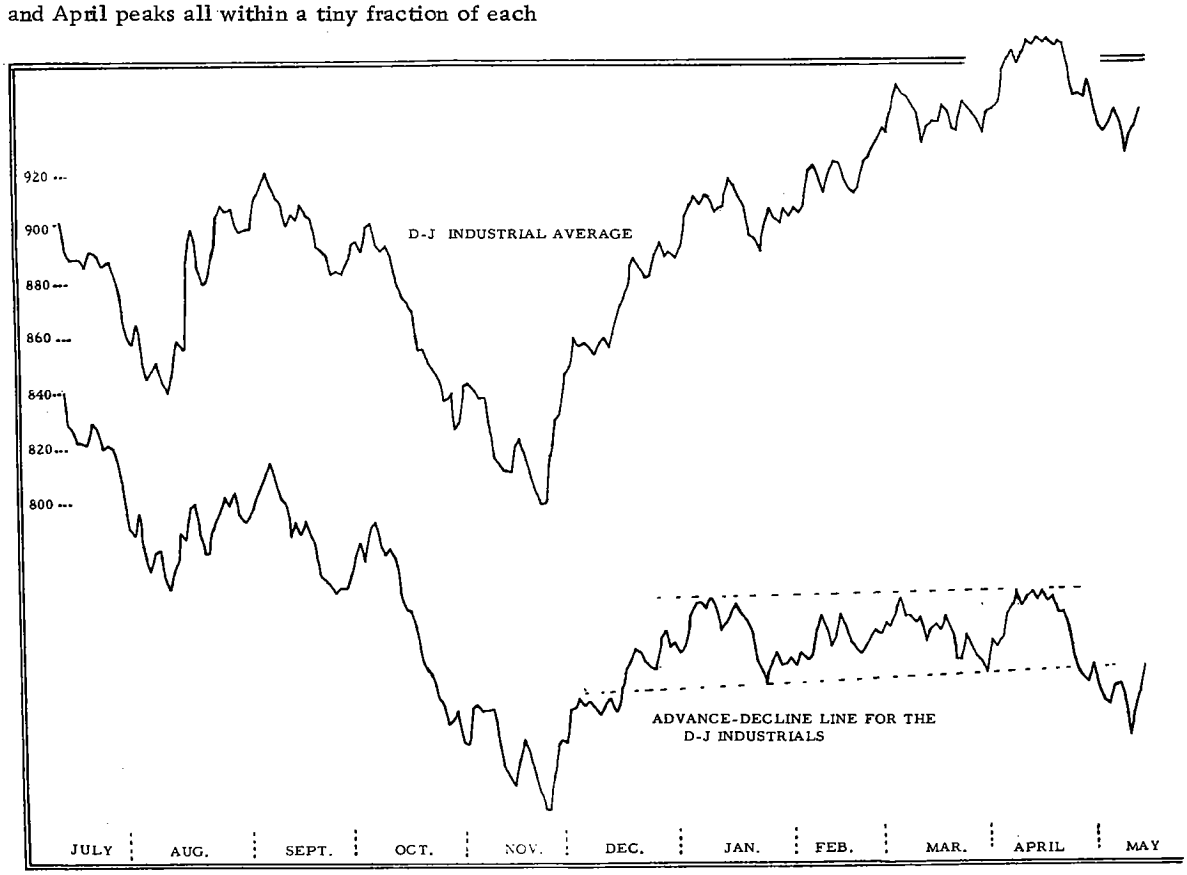
The accompanying chart shows the Industrial Average and its A-D ratio over the past 11 months. Note that during the September sell-off of 1971, the ratio plunged below the August low. This was followed in October and November by a decline of the Dow below its own August low, so that the greater weakness of the ratio tipped off the coming weakness in the Dow.



In Letter 522 of this year I noted that the ratio was straining and was not reflecting what seemed to be superior strength in the Dow. Actually, the Dow A-D ratio recorded its peak on January 11, despite the fact that the Industrial Average continued to establish new recovery highs. By mid-April a "triple top" had formed in the ratio with the March and April peaks all within a tiny fraction of each other. The ratio had been moving sideways since the January 11 top, despite the continued push of the Dow.

The only answer to this technical puzzle was that strength was being confined to a limited number of Dow stocks, not enough to move the ratio higher. This type of divergence was bound to signal trouble in due time.

The trouble came in mid-April. Faced with the technical problem shown on the chart, the Dow turned sharply lower. By May 1 the Dow A-D ratio had broken below its January



low points. By May 3 the ratio has declined to its December 14 level, a level which saw the Industrial Average at 855.

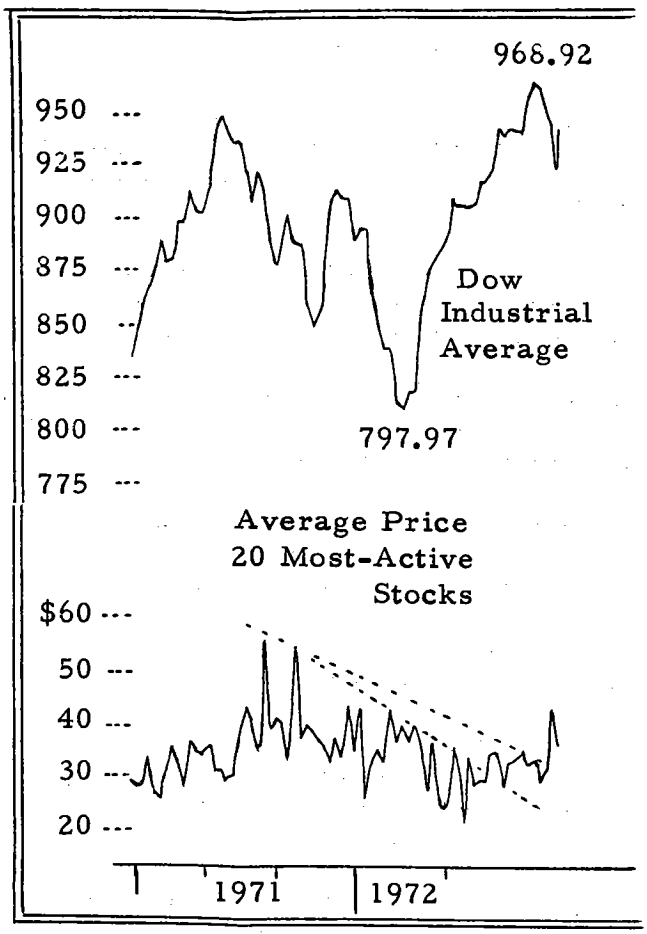
Thus the Dow A-D ratio has told a most interesting story over the past year. I would say that the ratio is saying that the path of least resistance is now down, and that the technical structure of the Dow is still very precarious (with the majority of Dow stocks refusing to make any consistent upside progress since the January 11, 1972, peak).

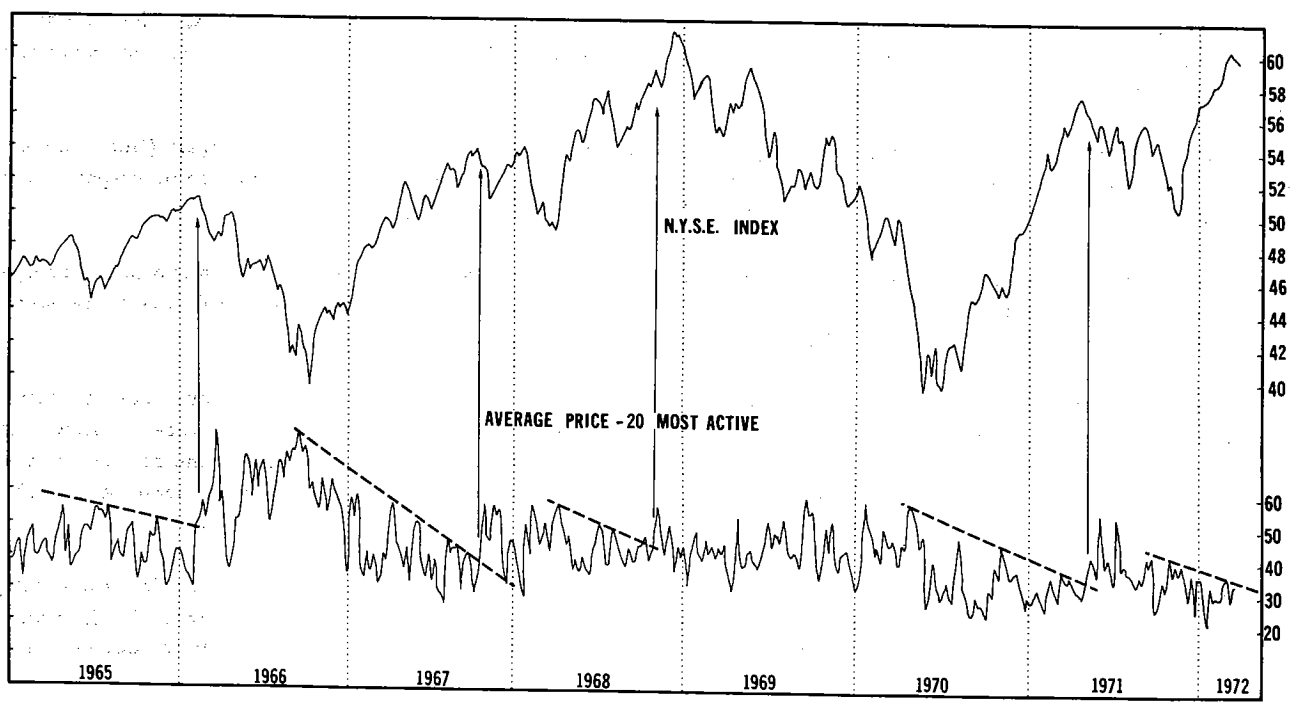
SPECULATION AND FEAR: The following is a phenomenon which I have not discussed before. It is that as a market movement progresses on the upside, it usually brings in an increasingly more speculative following. This trend can be seen in the weekly average price of the 20 most-active stocks.

As a rule, the higher the average price, the more certain we can be that the "active" buying is on an investment level. As the advance continues, the public starts to come in, and since the public prefers the low-priced numbers, the average price of the most-active stocks begins to recede. Finally, as the advance nears its end, the average price may be perhaps half or less what it was when the advance began. Many speculative low-priced issues are making the most-active list, and it is not unusual for the average price of the most-actives to drop to around $30 per share.

Then the "unconscious" of the market seems to sense trouble, and there is an abrupt rise in the quality of the most-active buying. This rise in the average price often marks the beginning of trouble for the market. It means that Wall Street has suddenly "felt" that something is wrong, and the activity is switching back to the safety of the higher-priced quality issues.

All this is documented beautifully on the lower chart (included through courtesy of Comparative Market Indicators, Box 1557, Bellevue, Wash. 98009). Note that each descending trendline of the chart traces a steady decline in the price (or quality) of the most-active stocks. Then, as the trendline is broken on the upside (this is the return to safer, higher-priced quality) the trouble starts for the general market.





I have included my own up-to-date weekly chart (page 3) of the Dow Industrials and the average price of the 20 most-active stocks. I have drawn two trendlines. The first one was broken on the upside during mid-February, 1972, but the upside penetration seemed sub-standard, and the average price did not rise above $35. The average price of the most-actives then held in the $30 to $35 range, and although I took the first (or lower) trendline penetration as an early warning sign, I did not feel that this indicator was saying "danger" yet.

But on the week ending May 5, the average price (which is listed on Barron's Laboratory Page each week) jumped to $43.02, its highest level of 1972. This I took as a true signal that Wall Street was running to the safety of higher-priced quality issues. The danger signal has been given by this indicator.

DEBT: In a recent issue of Nation's Business, Rep. George H. Mahon (D. Texas), who is chairman of the powerful House Appropriations Committee wrote an article suggesting that the "US is heading for financial disaster." Mahon points out that if one eliminates the trust fund surpluses (from social security and other sources), the true deficit for the current fiscal year will be $44.7 billion.

By the same method, the 1973 deficit is now estimated to be $36.3 billion. "In other words," says Mahon, "in these two consecutive years alone we stand to really go in the red by an additional $80.9 billion. And we still face 14 months of uncertainties and relentless pressures before the books are finally closed on fiscal 1973."

Counting the new budget, says Mahon, "in the last 43 years we have had deficit in 32 years, good times and bad times, no matter what budget (method of computing) is used." In the fiscal years 1970 through 1973 the national debt will have rocketed from $367 billion to an incredible $490 billion.

Now here is the staggering part. States Mahon, "...about one fourth of that enormous debt is being piled up in this four-year period alone!" He adds, "We are spending over $21 billion a year just to pay interest on the debt. That sum was sufficient to run the entire federal establishment only about 30 years ago."

We were going into debt at the rate of about $10 billion a year during the 1960's. During the 1970's we are moving into debt at about four times that rate. "This is a dismal picture," comments Mahon, "of a nation spending itself into oblivion."

Mahon notes that federal programs now in the till will soak up all the money which it is hoped will come into government tills due to growth in the economy for years to come. My only comments is, what happens if a business decline hits and instead of growth in tax receipts, there is a huge decline in those receipts? It is a situation too pathetic or absurd to contemplate — but one we may well have to face in just a few years.

GOLD: Doubtless, a great number of my subscribers read the article in the May 8 issue of the Wall Street Journal entitled "A Currency Shake-Up, A Secret IMF Proposal for Monetary Reform Urges Radical Changes." The article was, in its way, a shocker, and perhaps prophetically, the price of gold in London shot up over a dollar on that day (gold closed at a new record high of $52.07).

The story concerned a "secret memorandum" of the IMF which gave many clues regarding what Europe wants. The proposal may be a sort of "hint" to the US as to what lies ahead. At any rate, some of the IMF stipulations are calculated to play havoc with the US's printing press activities.

According to the memorandum, the US will have to be prepared to devalue again, and perhaps again and again (like many other debtor nations). The US should also be prepared to see tens of billions of dollars turned into the IMF and then be prepared to buy these dollars back.

I will not go into all the proposals, but perhaps the most explosive is the one that calls for an annual or even quarterly "compulsory conversion" of dollars. This means that if the US runs up one of its usual whopping deficits, that deficit will have to be paid off at a stipulated time in a like amount of gold, SDR's, or some other currency or asset.

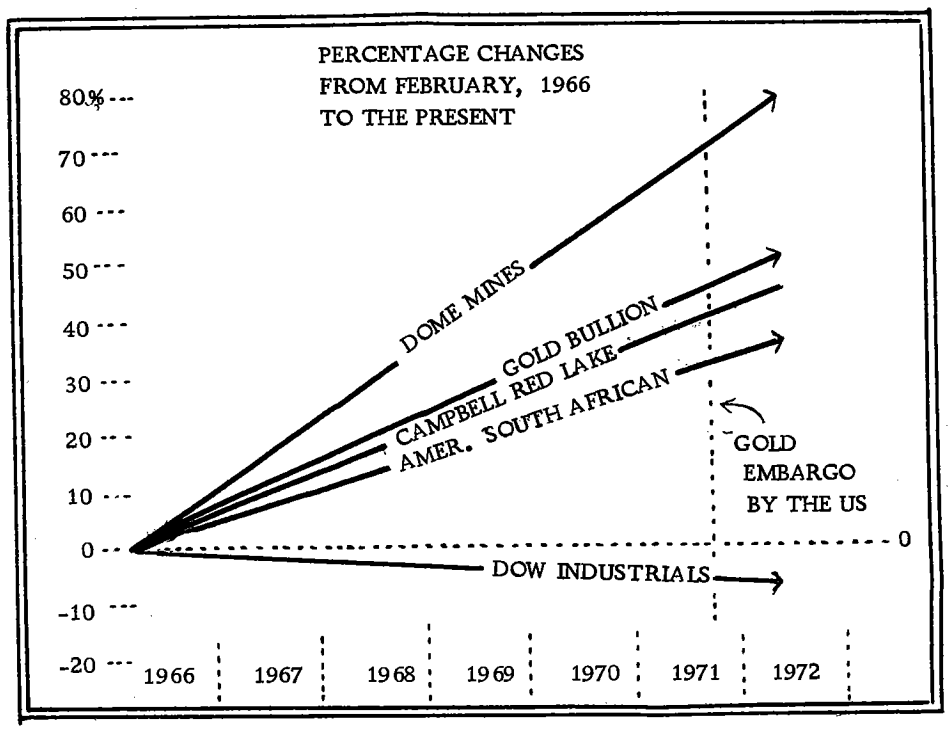
Can you imagine the US being put in the position of having to pay off its international deficits? We might even have to stop inflating, printing "play" money, and start getting competitive again. Remember, this is the first time in recent history that the US has been in the position to having to listen to its creditors. Up to this time, we have been handling the people we owe money to by ignoring them or blackmailing them with threats of trade restrictions or pulling out troops out or some other such nonsense.

Meanwhile, the men who speculate or invest in gold seem to suspect that something "big" is in the wind. I don't know exactly what it could be, but I do feel that there is only one way for the world to get out of the current mess, and that is for the price of gold to be fixed at a new, very high multiple of the present price (say $114 or $152 per ounce), for the US to become vastly

more interested in productivity (which means totally halting inflation and becoming vastly more efficient). It also means that the US must cut expenses drastically (and the most obvious area is military expenses including Vietnam and armaments).

Personally, I believe that most Americans detest the arms economy, that they would be willing to sacrifice much to get out of this death-race. There are others who say that we cannot survive vast dislocations in our defense industries. I can only say that we cannot survive with the kind of money we are now budgeting for military hardware. The era of great disillusionment is coming, I feel, and one of the disillusionments is going to be the monstrous, scandalous wastes and immoralities connected with our armaments industries. The public is not yet ready to hear the facts, when they are, it will include a list of wealth-squandering the likes of which will curl the hair of Americans and foreigners alike.

MORE ON GOLD: I am being literally besieged by questions from subscribers regarding the gold picture, the price of gold, and the action of the gold stocks. I have drawn this chart in order to put the whole picture in some kind of perspective.



History shows that almost all major monetary dislocations have been followed, usually within four or five years, by economic depressions. I would say that the current monetary mess began boiling in 1968, and that suggests that economic trouble should start hitting in the next year or so.

No two periods of history are exactly alike, but many have significant similarities. For instance, the gold embargo of the 1930's (it actually occurred in early 1933) came after the depth of the Great Depression, and after the stock market collapse of 1929 to 1932. During the period of 1929 to 1933 the Dow Industrial Average lost almost 90% of its value. The price of gold was boosted in 1934 from $20.67 per ounce to $35, a rise of about 70%. Dome Mines (which was wholly a gold producer in those days) gained 125% in price and Homestake, the US's largest gold mine, gained 150% in value. After the embargo of gold was over the gold stocks continued to climb until Dome had gained 300% in price and Homestake over 400%.

The chart I have drawn shows what has happened from the February 9, 1966, bull market peak of 995.15 on the Dow Industrial Average up to last week. The biggest gainer has been Dome Mines, which is now a holding company (controlling interest in Campbell Red Lake plus petroleum interests). Dome has gained almost 80% since February, 1966. Gold bullion is up over 50% in value. Campbell Red Lake has added over 40% to its value since February, 1966. American-South African, an investment trust, is up better than one-third, and the Dow Industrial Average is down about 6%.

I believe one major difference in the current period and that of the 1930's is public psychology. This has come about because the US Government has been attempting (rather successfully) to convince the public that it can control the forces of supply and demand. For years the Government has been talking about permamently "removing" the "barbarous relic" as a monetary base. And despite the fact that 5,000 years of recorded history says that it can't be done, the mass of Americans tend to believe their Government.

The fact is that today's generation of investors is woefully ignorant about monetary affairs. They have had little experience with "gold wars," toppling currencies and financial panics. They have been taught that the US is invincible on all fronts. But history shows that in the face of inflation, only gold is invincible. When governments turn to the printing presses to solve their financial problems, prudent men turn to gold to protect their assets.

Ironically, we read almost daily that the price of gold is climbing because of the short supply of gold for "commercial purposes" or for "fabrication and jewelry" or that gold has been run up "by the speculators." Nobody admits that gold is simply the prudent man's hedge against a government which is stealing via the inflation route.

As the US pursues its wild spending plans in the face of a Europe which is aghast (as it sees its vast horde of dollars shrinking in value), I expect the trends on this chart to continue. I expect the gold related vehicles on the plus side of the chart to climb higher. And I expect the Dow Industrials to work lower. The final result, if the present trends continue (and by this I mean the avenues being followed by the US Government) will be a business depression. We will witness a total collapse of confidence in the dollar, a boom in the price of gold and gold shares, and a public panic as the crowd realizes that they have been duped by a series of Administrations which have had wrong motives and been pursuing wrong values. (Note: other services are free to reproduce the page 5 chart while giving proper credits).

Meanwhile, despite the record highs in the price of gold bullion, the gold stocks are not keeping up with the price of the yellow metal. I have received many calls from subscribers asking why. In answer, I can only say again that I feel gold shares are still faced with massive skepticism on the part of the professionals and the public. The fact is that the price of gold is up almost 50% over the levels of a few years ago, nothing has been solved on the international monetary front, the position of gold is as strong or stronger than ever in international thinking, but the gold stocks are not at new highs. Why is this?

In answer I have written an imaginary conversation between an investor and a bullish advisor which may have taken place around mid-1949, when the Dow Industrials were in the 160 range. I think we can apply this thinking to the gold share picture today.

"Look, don't bug me about buying stocks, will you Harry? I know all your arguments. The Dow is selling at 7 times earnings, it's down at it's low range of the past four years, price-earnings ratios have never stayed this low for long. I know all about it. I know there's a recession on, and that when it's over earnings should be headed up. But I'm not buying stocks Harry. You guys have been talking about the big post-War boom ever since 1945. Yeah, a boom that would match 1921-29, but where are we? Back in the 160's on the Dow. No Harry, I know the Dow is cheap by historical standards, but I'm hanging on to my dough. The fact is that you and I are going to be old men before the Dow ever get near the 1929 highs again."

But the fact is that all during 1946 to 1949 the Dow was forming a massive base, from which the 1949 to 1966 primary bull market was to flower. I include here a chart of the South African Gold Average (statistics available weekly in Barron's) from the period of 1965 to the present.

Note the 1967 and 1970 "bottoms." Then notice that during 1971 the bottoms were briefly penetrated in what seemed to be a final "shakeout" of the gold stocks. Following the 1971 low, the gold Average formed what appears to be a large "head-and-shoulders" bottom with the neckline (or line of resistence) at the 60 level. Over the past two weeks the 60 level was penetrated on the upside, and many of the S. African golds made important upward moves.

I would say that the lows for the S. African golds are now past, and that these stocks will now be reflecting the gold picture closely as Europe prepares for its Fall monetary meetings. In the meantime, the gold base has been completed, and I would expect the US anti-gold propaganda to exert less and less effect on the prices of gold shares.

NOTE: Just no room for the regular gold-silver chart this time, but it will appear in the next report. Gold was $53.10 on the final fixing (London) for May 15, and it appears very strong. Silver is gradually working away from its base, and is appearing "cheap" in relation to the steadily climbing gold price. Numberous advertisements are appearing for silver medallions, bars, coins, etc., and I suspect a great deal of silver hoarding is now beginning.